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C O N F I D E N T I A L SECTION 01 OF 02 ISTANBUL 000418

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TREASURY FOR U/S TAYLOR AND OASIA - MILLS
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TAGS: ECON EFIN PREL TU
SUBJECT: ISTANBUL ECONOMIC ANALYSTS: LOOKING FOR A LIFELINE

Classified By: Pol/Econ Chief Stuart Smith. Reasons 1.5 (b) and (d).

¶1. (SBU) Summary: After a rocky start to the week on Monday, word that the U.S. Iraq supplemental contains 1 billion USD for Turkey has been seized on as a lifeline by Istanbul markets and analysts. Concern persists about the sustainability of Turkey's debt, however. Analysts suggest any problem is unlikely to emerge immediately, as banks will remain in the market and move to shore up their balance sheets at the end of the quarter and cooperate with the government to bring interest rates down. The key wildcard that could hinder that effort: individual bank's dollar liquidity. One banking contact estimates that 5 percent of the system's 44 billion USD in assets has been withdrawn or transferred overseas in recent days, a figure confirmed in Ankara by BRSA sources (septel). Other banks report that after an initial "leakage" on the first day of hostilities, the situation has stabilized. Banking industry leaders reviewed the situation in Ankara on March 26 with the Treasury, Central Bank and BRSA. End Summary.

¶2. (C) No credibility: Our contacts in Istanbul's financial community are extremely critical of the AK government and its mishandling of U.S. relations on Iraq. Its mixed signals on reintroducing the motions to support the U.S., and the perception that State Minister Babacan deliberately misled the markets before the Treasury's last debt auction, have left its credibility in shreds. The distrust was evident over the weekend as Prime Minister Erdogan's message of commitment to economic reform failed to sway market sentiment. Analysts at Bender Securities argue that "this government is finished." But, of equal concern, many perceive that the problem extends beyond the government. Yapi Kredi's Huseyin Imece characterizes the failure as one in which the entire Turkish state shares responsibility, from the President and military through the oppositin as well.

¶3. (SBU) Isolation: Beyond the loss f American financial assistance, which some see s survivable (Finansbank's Kerim Kemahli notes tat Turkey was expected to muddle through before he package appeared, and can still do so), concern among Istanbul observers focused especially on a erception that Turkey's bridges to the West and articularly to the U.S. have been cut. EU warnigs on Cyprus, coupled with warnings from all quaters against Turkish intervention in Northern Ira ("the last error remaining for Turkey to commit" in Imece's description), shook the markets and contributed to
nday's sharp sell-off. Tuesday'sreport of a new and more modest U.S. assistance ackage has thus been seized on as a lifeline. Analysts recognize that the amount (in the Turkish ontext) is relatively insignificant, and congresional approval by no means assured, but nonetheless, in Kemahli's and others' view, the aid is an important signal that the U.S. administration is not abandoning Turkey. (Garanti Bank's Baris Kokoglu argued that even a promise of billions from the EU would have less market impact than the U.S. billion.)

¶4. (SBU) Debt Sustainability: All observers are now focused on interest rates, Turkey's key economic indicator. While pessimism is marked at local brokerages (Bender's Murat Gulkan and Emin Ozturk see an economy trying to navigate between muddling through and "doomsday," with no real upside), some bankers are more sanguine. Kemahli argues that the "moderate" reaction of the past week shows that the Turkish economy has matured since the 2001 crisis, and will weather the storm. The banking sector is strong, he argues, with banks liquid and without exposure to short positions on the dollar. Banks are taking paper losses because current high rates negatively impact their balance sheet, but he and his colleague Ozlem Cinemre characterize this more as an "opportunity cost," in that deposit rates are so low the banks are still making money on their entire portfolio. Garanti's Kokoglu agrees, noting further that the banks have no alternative but to stay in the bond market. There is no

demand in the real sector for loans, reserve requirements provide an incentive for bond holdings over loans in any case, and other securities (such as U.S. bonds) do not offer a high enough return to cover Turkish deposit rates. Bender analysts characterize the situation as a "Hotel California," where all players are enjoying good profits, but cannot exit the game.

¶5. (SBU) Dollar liquidity: Given that ten banks constitute the key market for Turkish t-bills, their liquidity is critical to debt turnover. On this issue, we are hearing mixed messages. Yapi's Huseyin Imece warned that "leakage" from the system has reached 5 percent of its 44 billion USD in total dollar assets, a figure confirmed by BRSA's Engin Akcakoca, who told Embassy Ankara (see Ankara septel) that FX withdrawals from March 14-15 totaled 1.8 billion USD. Not all banks are being equally affected, however. Cinemre and Kemahli noted that while there were some withdrawals on the first day of military operations in Iraq (2 percent of the Finansbank's 1.8 billion USD holdings), the situation had since stabilized and that on Wednesday there was even a 20 million USD inflow. They noted too that withdrawals were not driven by panic, as they were 2 years ago (when Finans was forced to turn to merchants in the Grand Bazaar and its German branches for stopgap liquidity), but by large depositors comparison shopping in pursuit of increased returns. Kokoglu reported a similar pattern at Garanti. However, he confirmed that the CEO's of major banks were meeting in Ankara on March 26 with the BRSA, Central Bank, and Treasury to review the situation and emphasized the importance of Turkey's continued commitment to its reform program. The government no longer has any margin for error, he stressed, and the markets will "swiftly punish" any missteps.

¶6. (SBU) Comment: From the Istanbul perspective, what started as an extremely problematic week has been salvaged by the public perception that the U.S. is not abandoning Turkey. Analysts are united in their belief that to further soothe the markets Turkey should avoid raising tensions by going into Northern Iraq. After the announcement of U.S. assistance, they also see value in a reciprical goodwill gesture by Turkey--such as opening airbases-- without seeking a quid pro quo. Most of all, they are looking for actions rather than words from the government on the economy. We were struck, however, by the dividing line between the views of Istanbul's bankers and stock market analysts. While the latter are uniformly gloomy, some of the former were more sanguine--convinced that Turkey has seen worse before and will ultimately weather the crisis, provided the war is short and the government continues to follow IMF guidance. End Comment.
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